Office of Chief Counsel
Internal Revenue Service

memorandum

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GAKindel

date: MAR 2 2 1999

to: Examination Division, Southern California District
ATTN: Richard Woods, Team Coordinator, CE 1108

from: Associate District Counsel, San Diego

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subject: [redacted] -- Acquisition and Transfer of Stock

This memorandum responds to your request for advice regarding (1) the acquisition by [redacted] (the "Taxpayer) of stock in [redacted] through a plan of reorganization and (2) the subsequent transfer by the Taxpayer of the stock in [redacted] to another shareholder.

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the Taxpayer properly treated the transaction in which it exchanged its stock in [redacted] for stock in [redacted], warrants to purchase stock in [redacted], and cash as (a) a tax-free exchange covered by I.R.C. § 351 and (b) a redemption covered by I.R.C. § 302(b)(3).

2. Whether the transaction identified in Issue 1 qualifies as a tax-free reverse triangular merger.

3. Whether the Taxpayer properly treated the loss realized on the transfer of its stock in [redacted] to [redacted] as an ordinary loss, where:

   a. the Taxpayer transferred its stock in [redacted] to [redacted] in exchange for a "Mutual Release of Claims" and

   b. [redacted] treated the transfer as a "purchase price adjustment" to reflect that the value of the Taxpayer's stock in [redacted] was overstated at the time of the transaction identified in Issue 1.

4. Whether the Service should allow the Taxpayer an ordinary loss pursuant to I.R.C. § 165(g)(3) with respect to advances made by the Taxpayer to [redacted] and a capital loss on the sale of [redacted]'s stock.

CONCLUSIONS

1. No. The form of the transaction is a reverse triangular merger, not an exchange with a controlled corporation. I.R.C. § 368(a)(2)(E) was enacted to address the tax consequences of reverse triangular mergers. As a result, I.R.C. § 351 is not applicable.

2. No. Although the transaction meets the requirements of I.R.C. § 368(a)(2)(E), it does not satisfy the requirement for "continuity of interest." The Taxpayer transferred nearly [redacted] percent of its stock for cash and [redacted] percent for stock in [redacted]. The Taxpayer did not preserve a substantial portion of the value of its interest in [redacted]. Therefore, the transaction should be treated as a sale of the Taxpayer's stock in [redacted].

3. No. The transfer of the Taxpayer's stock in [redacted] to [redacted] should be considered as part of the transaction involving the reverse triangular merger. As such, the transfer results in a capital loss.

4. No. (b)(7)e [redacted]. I.R.C. § 165(g)(3) relates to worthless securities of an affiliated corporation, not bad debts. Nonetheless, it appears that the Service is attempting to recast the transaction as something other than a reverse triangular merger. (b)(7)e [redacted].

FACTS

Parties

[redacted] (the "Taxpayer") is a Delaware corporation doing business in San Diego, California. The Taxpayer owns and operates several chain restaurants, most notably the [redacted] Restaurants. The Taxpayer uses a 52-53 week year as its taxable year.

[redacted] ("[redacted]") is a Delaware corporation, which prior to [redacted], was a wholly-owned subsidiary of the Taxpayer. [redacted] owns and operates a chain of [redacted] restaurants called [redacted]. Prior to [redacted], [redacted] had [redacted] shares of common stock issued and outstanding.

[redacted] ("[redacted]") is a Delaware corporation formerly known as [redacted] ("[redacted]"). [redacted] owns and operates various restaurant chains, including [redacted], [redacted], and [redacted].

[redacted] ("[redacted]") is a Delaware limited partnership unrelated to the Taxpayer.

Acquisition of [redacted]

In [redacted], the Taxpayer and [redacted] announced their intentions to acquire [redacted] for the purpose of forming a new company to operate the [redacted] restaurants along with [redacted]'s restaurants. In [redacted], the majority shareholder of [redacted] agreed to a bankruptcy reorganization of [redacted].

On [redacted], the Taxpayer, along with two other investors, [redacted] and [redacted] ("[redacted]"),[1] entered into an Acquisition Agreement with [redacted]. The Acquisition Agreement consists of two parts: (1) purchase of [redacted] stock by [redacted] and [redacted] and (2) merger of a newly formed subsidiary of [redacted] with and into [redacted].

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[1] [redacted] is a limited partnership unrelated to the Taxpayer.

The reorganization plan that was filed with the bankruptcy court does not set forth the specific details of the Acquisition Agreement; it simply refers to the Acquisition Agreement. Pursuant to the reorganization plan, the shareholders and creditors of [redacted] did not receive any stock in [redacted] or [redacted].

Part 1 -- Purchase of Stock by [redacted] and [redacted]

[redacted] agreed to purchase [redacted] shares of common stock in [redacted] for $[redacted] per share, while [redacted] agreed to purchase [redacted] shares.[2] See Acquisition Agreement, § 2.1(a). [redacted] contributed $[redacted] in cash for its shares, which constituted a [redacted] percent interest in [redacted]. See Form 10-K, Annual Report, Consolidated Financial Statements, Note 3 (filed [redacted]). [redacted] contributed $[redacted] in cash for its shares, which constituted an [redacted] percent interest in [redacted]. See id. Certain management-level employees of [redacted] contributed $[redacted] in cash and notes for shares constituting a [redacted] percent interest in [redacted]. See id.

Part 2 -- Merger of Subsidiary with [redacted]

[redacted] agreed to form a subsidiary, called [redacted] ("Merger Sub"), for the purpose of merging into [redacted]. See Acquisition Agreement, § 2.1(b). Merger Sub was incorporated on [redacted]. See Agreement and Plan of Merger (the "Merger Agreement"), attached as Exhibit E to the Acquisition Agreement. On that date, [redacted] transferred to Merger Sub the following:

1. [redacted] shares of common stock of [redacted]
2. warrant to purchase [redacted] shares of new common stock of [redacted] at $[redacted] per share (the "Warrant"); and
3. an amount of cash equal to $[redacted] less the principal amount of capitalized leases and face amount of indebtedness of [redacted].

See Acquisition Agreement, § 2.2(b).

In the Acquisition Agreement, the Taxpayer represented the following:

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[2] Certain management-level employees purchased shares of [redacted]'s common stock. These purchases reduced the number of shares ultimately purchased by [redacted] and [redacted] to [redacted] and [redacted], respectively. See the Taxpayer's response to IDR FM-07 and the Taxpayer's "Statement under Regs. 1.351-3(a)."

> Schedule 5.2 hereto sets forth and describes all outstanding indebtedness (including capitalized lease obligations) of [redacted] and each of the [redacted] Subsidiaries. Except as set forth in the Disclosure Statement on the date hereof, neither [redacted] nor any of the [redacted] Subsidiaries has, or immediately following the Closing will have, any material liabilities or obligations of any nature, absolute, accrued, contingent or otherwise (including, without limitation, liabilities for Previously Divested Operations of [redacted]) other than liabilities or obligations incurred after the date hereof in a manner not prohibited by Section 6.4 hereof, which liabilities or obligations are disclosed in the Registration Statement on the date it is declared effective. The principal amount of capitalized leases and the face amount of indebtedness (other than amounts owing to third parties in respect of trade payables, accrued liabilities, deferred income, straight line rent, CAPE withholding and matching, deferred gains on sale leasebacks, unclaimed property and other liabilities) to be retained by or assigned to [redacted] and its Subsidiaries immediately prior to the merger shall not exceed $[redacted] and $[redacted], respectively.

See Acquisition Agreement, § 5.2(d). The Taxpayer claims that Schedule 5.2 identifies two liabilities not retained by [redacted], (1) an "Intercompany Payable" in the amount of $[redacted] and (2) a "Bank Debt" in the amount of $[redacted]. See the Taxpayer's response to IDR FM-07. The Taxpayer claims that it assumed these liabilities as part of the merger transaction. Id.

The "Intercompany Payable" apparently refers to advances made by the Taxpayer to [redacted]. It is unclear to what the "Bank Debt" refers.

Pursuant to the Merger Agreement, on [redacted], Merger Sub merged with and into [redacted]. At that time, each outstanding share of [redacted] common stock was converted into the right to receive a pro rata share of:

1. [redacted] shares of common stock of [redacted];

2. a warrant to purchase an aggregate of [redacted] shares of new common stock of [redacted] for $[redacted] per share; and
3. $[redacted] in cash.[3]

See Merger Agreement, § 1.2(a). Also at that time, each outstanding share of Merger Sub's common stock was converted into one share of [redacted] common stock. See Merger Agreement, § 1.2(b).

Treatment by the Taxpayer

The Taxpayer treated the transaction as both an exchange pursuant to I.R.C. § 351 and a redemption pursuant to I.R.C. § 302(b)(3). The Taxpayer states:

> Under the terms of the agreement, a newly-created, wholly-owned subsidiary of [redacted] was merged into [redacted] with [redacted] becoming the surviving corporation. The merger transaction is described in the Agreement and Plan of Merger. The merger itself had no tax impact on the transaction as it relates to [redacted]. However, this agreement reiterates the amount of cash and stock received in the transaction.

See the Taxpayer's response to IDR FM-07.

The Taxpayer computed the amount realized on the transaction as follows:

Amount Realized	
[redacted] stock	$[redacted]
Cash	[redacted][4]
Total	$[redacted]

[3] The term "Merger Consideration" is defined in the Acquisition Agreement as (a) [redacted] shares of common stock of [redacted], (b) warrant to purchase an aggregate of [redacted] shares of common stock of [redacted], and (c) cash equal to $[redacted] less the principal amount of capitalized leases and face amount of indebtedness of [redacted]. See Acquisition Agreement, § 1(a). Again, certain management-level employees purchased shares of [redacted]'s common stock. These purchases reduced the number of shares ultimately received by the Taxpayer to [redacted]. See the Taxpayer's response to IDR FM-07.

[4] The Taxpayer states that it received $[redacted] in cash, instead of the $[redacted] as listed in the Merger Agreement. See the Taxpayer's response to IDR FM-07.

The Taxpayer did not include any value for the Warrant in the amount realized. See the Taxpayer's response to IDR FM-07.

The Taxpayer claims that, at the time of the transaction, its basis in the [redacted] stock was $[redacted] and that its basis in the "Intercompany Payable" and the "Bank Debt" was $[redacted] and $[redacted], respectively. See the Taxpayer's response to IDR FM-07. The Taxpayer, therefore, claimed a basis of $[redacted] ($[redacted] + $[redacted] + $[redacted]). See the Taxpayer's response to IDR FM-07.

The Taxpayer then allocated the amount realized and basis between the section 351 transaction and the redemption transaction using percentages equal to the ratio of the amount realized in each transaction to the total proceeds. See the Taxpayer's response to IDR FM-07.

351 Transaction

value of [redacted] stock ÷ total proceeds = percentage attributable to 351 transaction

$[redacted] ÷ $[redacted] = [redacted]%

Redemption Transaction

cash received ÷ total proceeds = percentage attributable to redemption transaction

$[redacted] ÷ $[redacted] = [redacted]%

The Taxpayer, therefore, computed the amount of gain/loss from each transaction as follows:

351 Transaction

Amount Realized	$[redacted]	([redacted] x $[redacted])
Basis	($[redacted])	
Loss		

Redemption Transaction

Amount Realized	$[redacted]	([redacted] x $[redacted])
Basis	($[redacted])	
Loss		

See the Taxpayer's response to IDR FM-07.

As a result of the section 351 transaction, the Taxpayer did not recognize any loss. With respect to the redemption transaction, the Taxpayer elected to attribute to itself any net

operating losses attributable to [redacted], pursuant to Treas. Reg. § 1.1502-20(g)(1). See the Taxpayer's response to IDR FM-07. On its income tax return, however, the Taxpayer identifies the loss disallowed pursuant to Treas. Reg. § 1.1502-20(a)(1) as $[redacted], not $[redacted].

Transfer of [redacted]

As a result of negative publicity regarding the nutritional value of [redacted] food, [redacted] wrote off the goodwill attributable to [redacted] in the fourth quarter of [redacted]. The Taxpayer wrote down its entire investment in [redacted] in the first quarter of [redacted] as a result of the goodwill write-off.

In [redacted], [redacted] continued to have substantial losses and needed additional funds to operate. Before the creditors would advance any additional funds to [redacted], the shareholders of [redacted] had to enter into participation purchase agreements. The Taxpayer did not want to enter such an agreement for these additional advances. See Form 10-K, Annual Report, Consolidated Financial Statements, Note 3 (filed [redacted]).

At the same time, [redacted] began rumbling about certain claims that it had against the Taxpayer in connection with the acquisition of [redacted] by [redacted]. See Minutes of the Board of Directors, [redacted]. Specifically, [redacted] claimed that the Taxpayer had misrepresented the value and profitability of [redacted].

On [redacted], the Taxpayer and [redacted] entered into an Exchange Agreement, in which [redacted] acquired all of the Taxpayer's shares of [redacted] stock, including the Warrant, in exchange for a "Mutual Release of Claims." Pursuant to the Mutual Release of Claims, [redacted] released the Taxpayer "from any and all rights, claims, expenses, debts, demands, costs, contracts, liabilities, obligations, actions and causes of action of every nature, whether in law or equity, whether known or unknown, foreseen or unforeseen, arising out of or related to the Acquisition Agreement . . . dated as of [redacted], . . ." See Mutual Release of Claims, ¶ 1. The Taxpayer released [redacted] "from any and all Claims." See Mutual Release of Claims, ¶ 2.

The Taxpayer reported an ordinary loss in the amount of $[redacted] on the transfer, claiming that it did not receive any consideration for the [redacted] stock, that, therefore, the loss realized on the transfer did not result from a "sale or exchange," and that I.R.C. § 165(a) is the controlling provision. See the Taxpayer's response to IDR FM-11.

[redacted], however, treated the transaction quite differently. [redacted] described it as follows:

> Subsequent to the [redacted] Investment, [redacted] began to experience financial difficulties adversely affecting its financial condition. During this period, issues arose with respect to, among other things, the value of certain of the property contributed to [redacted] in the [redacted] Investment, and, in particular, the value of the stock of [redacted] contributed by [redacted]. These issues were resolved in [redacted] among the relevant parties through, among other things, an adjustment and revaluation of the [redacted] stock contributed by [redacted] and a transfer to [redacted] of [redacted]'s interest in [redacted] . . . After giving effect to this "purchase price" or "contribution adjustment" to the [redacted] Investment . . . [redacted] held approximately [redacted]% of the stock of [redacted]; [redacted] had no continuing interest. The transfer of the [redacted] Common Stock to [redacted] was effectively treated as a purchase price adjustment to reflect that [redacted] had overpaid for its [redacted]% original interest in [redacted].

See letter dated [redacted], from [redacted] to the Internal Revenue Service. [redacted] also notes that the value of the Taxpayer's [redacted] stock was de minimus.

The Service initially proposed a disallowance of the ordinary loss in the amount of $[redacted] on the grounds that there was a sale or exchange of a capital asset and that, as such, the loss was a capital loss.

The Service has reevaluated this proposal based on the information obtained from [redacted]. The Service now proposes to allow a "bad debt [pursuant to] I.R.C. § 165(g)(3)" with respect to the advances and a capital loss with respect to the sale of stock. The Service would allocate the cash received by the Taxpayer in [redacted] to the advances and the stock pro rata and would allow the loss to be claimed in [redacted], using an Arrowsmith analysis.

It is our understanding that the Service previously closed the examination of the Taxpayer's fiscal year ending [redacted], and that the Service has promised to close the examination of the Taxpayer's fiscal year ending [redacted], by the end of [redacted]. The Service, therefore, does not

intend to obtain any additional information on the transactions described above or to develop the issues further.

DISCUSSION

I. ACQUISITION OF [redacted] STOCK

A. SECTION 351

No gain or loss is recognized on the transfer of money or property to a corporation by one or more persons solely in exchange for stock in such corporation if, immediately after the exchange, such person or persons control the corporation. I.R.C. § 351(a). The term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all stock outstanding and at least 80 percent of the total number of shares of stock outstanding. I.R.C. § 351(a) and I.R.C. § 368(c).

The Taxpayer claims that I.R.C. § 351 applies to a portion of the transaction in which it, [redacted], and [redacted] acquired the stock of [redacted]. The Taxpayer claims that "[t]he merger itself had no tax impact on the transaction."

We disagree. The Taxpayer chose the form of the transaction. It chose to reorganize [redacted] using a merger of its subsidiary, [redacted], with a newly created subsidiary of [redacted], Merger Sub. Despite the Taxpayer's statements to the contrary, the Taxpayer did not simply transfer its shares of [redacted] stock to [redacted] in exchange for shares of [redacted] stock.

Arguably, Merger Sub was a transitory entity and should be disregarded in analyzing the tax consequences of the transaction. If Merger Sub is disregarded, the Taxpayer did transfer its shares of [redacted] stock to [redacted] in exchange for shares of [redacted] stock. I.R.C. § 368(a)(2)(E), however, was enacted to address the tax consequences of reverse triangular mergers. As a consequence, the tax consequences of the merger of Merger Sub with [redacted] must depend on the application I.R.C. § 368(a)(2)(E), and not I.R.C. § 351.

B. REVERSE TRIANGULAR MERGER

1. Statutory Provisions

No gain or loss is recognized if stock or securities in a corporation a party to a reorganization are, in pursuance to a plan of reorganization, exchanged solely for stock or securities in another corporation a party to the reorganization. I.R.C. § 354(a).

An exchange does not fall outside of I.R.C. § 354(a) simply because the persons exchanging stock or securities in the corporation receive money or other property in addition to stock or securities in the other corporation. See I.R.C. § 356(a). If I.R.C. § 354(a) would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted to be received but also of other property or money, then:

1. gain (if any) to the recipient shall be recognized, but not in excess of (a) the amount of money received, plus (b) the fair market value of property received; and

2. no loss to the recipient shall be recognized.

I.R.C. §§ 356(a) and (c).

As defined in I.R.C. § 368(a)(1), the term "reorganization" means, among other things:

> (A) a statutory merger or consolidation;
>
> . . .
>
> (G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.[5]

I.R.C. §§ 368(a)(2) and (3) provide rules for applying the definitions of "reorganization" set forth in I.R.C. § 368(a)(1).

A transaction otherwise qualifying under I.R.C. § 368(a)(1)(A)

> shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if -
>
> (i) after the transaction, the corporation surviving the merger holds substantially all of its

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[5] A transfer of the assets of a corporation shall be treated as made in a title 11 or similar case if and only if any party to the reorganization is under the jurisdiction of the court and the transfer is made pursuant to a plan of reorganization approved by the court. I.R.C. § 368(a)(3)(B).

> properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and
>
> (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

I.R.C. § 368(a)(2)(E). In the case of a title 11 or similar case, the requirement of clause (ii) above shall be treated as met if:

> (i) no former shareholder of the surviving corporation received any consideration for his stock, and
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> (ii) the former creditors of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, debt of the surviving corporation which had a fair market value equal to 80 percent or more of the total fair market value of the debt of the surviving corporation.

I.R.C. § 368(a)(3)(E).

In this case, as part of a plan for reorganization submitted to a bankruptcy court, [redacted] acquired [redacted] by merging its newly formed subsidiary, Merger Sub, with and into [redacted].

Bankruptcy and I.R.C. § 368(a)(1)(G)

We do not believe, despite the fact that the reorganization took place under the jurisdiction of the bankruptcy court, that I.R.C. § 368(a)(1)(G) applies to this transaction. I.R.C. § 368(a)(1)(G) was intended to cover transactions in which (1) the debtor corporation transferred all or substantially all of its assets to another corporation, (2) the debtor corporation received all or substantially all of the assets of another corporation, or (3) the debtor corporation created a new corporation by transferring all or substantially of its assets. The facts of this case do not fit into any one of these categories.

Merger and I.R.C. § 368(a)(2)(E)

It appears, from all of the information provided, that the merger satisfies the requirements of Delaware law. See Del. Code Ann. tit. 8, § 251 (1998). Therefore, at first blush, it appears that the transaction qualifies under I.R.C. § 368(a)(1)(A).

Upon further review, it appears that the transaction does not qualify under I.R.C. § 368(a)(1)(A), because the Taxpayer

received stock in [redacted], the "controlling corporation," instead of stock in Merger Sub, the merged corporation. [redacted] is not a "party to a reorganization" for purposes of I.R.C. § 368(a)(1)(A). See I.R.C. § 368(b).[6] Consequently, the transaction does not fall within the ambit of I.R.C. § 368(a)(1)(A).

The transaction, however, does fall within the ambit of I.R.C. § 368(a)(2)(E). First, [redacted] held all of its assets and all of Merger Sub's assets after the transaction, as required by I.R.C. § 368(a)(2)(E)(i). Merger Sub's assets consisted only of the consideration to be paid to the Taxpayer, i.e., stock in [redacted], the warrant for stock in [redacted], and cash. These assets are not taken into account in applying the "substantially all" test. Treas. Reg. § 1.368-1(j)(iii). Second, the Taxpayer exchanged stock in [redacted] constituting control of [redacted] for stock in [redacted], as required by I.R.C. § 368(a)(2)(E)(ii).[7] Stated differently, [redacted] controlled [redacted] after the merger, because it owned all of the issued and outstanding shares of [redacted] stock.

2. Continuity-of-Interest Doctrine

To be tax-free, a reorganization must meet the judicially-imposed requirement of "continuity of interest,"[8] in addition to the statutory requirements set forth in I.R.C. §§ 354, 356, and 368.

One aspect of the "continuity of interest" doctrine is the continuity of business enterprise. See Treas. Reg. § 1.368-1(d). There is no question here that [redacted] continued to operate [redacted] business after the transaction.

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[6] The term "party to a reorganization" includes "both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another." I.R.C. § 368(b)(2).

[7] We note that, if the merger of Merger Sub into [redacted] were intended to qualify under I.R.C. § 368(a)(1)(G), the merger would not satisfy I.R.C. § 368(a)(2)(E), because (1) the Taxpayer would not be allowed to receive any consideration for its stock in [redacted] and (2) the former creditors of [redacted] would have to exchange the debts owed by [redacted] for stock in [redacted]. The requirements of I.R.C. § 368(a)(3)(E), however, do not make any sense, unless [redacted] is the debtor and the party to the reorganization that is subject to the jurisdiction of the bankruptcy court. We believe, therefore, that the language of I.R.C. § 368(a)(3)(E) supports the proposition that I.R.C. § 368(a)(1)(G) does not apply to the facts in this case.

[8] This requirement is now set forth in Treasury Regulation §§ 1.368-1(b), (d) and (e).

The other aspect of the "continuity of interest" doctrine is the continuity of proprietary interest. Continuity of proprietary interest requires that "in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization." Treas. Reg. § 1.368-1(e)(1)(i) (emphasis added). A proprietary interest in the target corporation is preserved if it is exchanged for a proprietary interest in the acquiring corporation. Id. A proprietary interest, however, is not preserved if it is acquired by the acquiring corporation for consideration other than stock in the acquiring corporation. Id.

To meet the requirements for continuity of proprietary interest, the stock received from the acquiring corporation must have substantial value when compared to the value transferred. The Service has held that stock of the acquiring corporation equal to 50 percent of the value of the assets transferred is substantial for purposes of "continuity of interest." See Rev. Rul. 66-224, 1966-2 C.B. 114. The Supreme Court, however, found the requisite continuity of interest in a case where assets were transferred for consideration, 38 percent of which consisted of preferred stock and 62 percent of which consisted of cash. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

In this case, the Taxpayer received the following consideration for its shares of [redacted] stock:

1. [redacted] shares of common stock of [redacted];
2. the Warrant; and
3. $[redacted] in cash. (Again, the Taxpayer claims to have received $[redacted] in cash).

See Merger Agreement, § 1.2(a). Or stated differently, the Taxpayer transferred [redacted] shares of [redacted] stock in exchange for:

1. $[redacted] in [redacted] stock;
2. ?? with respect to the Warrant; and
3. $[redacted] in cash.

The Taxpayer claims that the Warrant did not have any value. The total consideration, therefore, equals $[redacted].

Assuming that the Warrant did not have any value, the Taxpayer received stock in [redacted] which constituted [redacted] percent of the total consideration received.[9] We do not believe that this

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[9] Step 1: total consideration = $[redacted] + $[redacted] = $[redacted]. Step 2: ratio of [redacted] stock received to total consideration = $[redacted] ÷ $[redacted] = [redacted]. The Taxpayer arrived at the same

constitutes the requisite continuity of interest for purposes of I.R.C. § 368.

3. Tax Consequences

The transaction, therefore, is treated as a sale of the Taxpayer's shares of [redacted] stock in [redacted].

Amount Realized

As stated above, the Taxpayer received at least $[redacted] in exchange for its shares of [redacted] stock. Again, this amount does not include the value, if any, of the Warrant.

Basis

The Taxpayer determined its basis in its [redacted] stock as follows:

Basis in Stock	$[redacted]
Intercompany Payable Assumed	[redacted]
Bank Debt Assumed	[redacted]
Total	$[redacted]

It seems logical to treat the Intercompany Payable as a conversion of the debt owed by [redacted] to the Taxpayer to equity. As such, the amount of the Intercompany Payable is includible in the Taxpayer's basis.

Gain or Loss

Assuming that the Warrant did not have any value, the Taxpayer realized a capital loss on the sale of $[redacted]. The Taxpayer can claim this loss in its fiscal year ending [redacted], but only to the extent of its capital gains. I.R.C. § 1211(a). The Taxpayer can carry back the capital loss back to each of the 3 taxable years preceding the one ending [redacted], and forward to each of the 5 taxable years succeeding such year. I.R.C. § 1212(a)(1).

It is our understanding that the Taxpayer did not have any capital gains in its fiscal year ending [redacted].

Basis in [redacted] Stock

The Taxpayer has a basis in the [redacted] stock received of $[redacted]. See I.R.C. § 1012.

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percentage in its analysis of the section 351 and redemption transactions.

II. DISPOSITION OF [redacted] STOCK

A. ORDINARY LOSS V. CAPITAL LOSS

1. Exchange of [redacted] Stock for Mutual Release of Claims

We previously have opined on the Taxpayer's argument that it is entitled to an ordinary loss on the transfer of its shares of [redacted] stock to [redacted] on the grounds that it did not receive any consideration for such stock and that, therefore, it did not sell or exchange such stock.

We disagreed with the Taxpayer on several grounds. First, the terms of the agreement between the Taxpayer and [redacted] expressly identify the transaction as an "exchange." Second, the Mutual Release of Claims did constitute consideration. Third, the Taxpayer's reliance on cases involving the "surrender" of stock is misplaced. The cases cited by the Taxpayer involve the surrender of stock to the issuing corporation. Despite the Taxpayer's assertions to the contrary, the Taxpayer did not "surrender" its [redacted] stock. It transferred the stock to [redacted]. And in exchange, it received consideration in the form of a release of claims and an agreement not to pursue litigation of those claims.

2. Arrowsmith Doctrine

The Service recently obtained information from [redacted] that sheds light on how to treat the transaction and provides an additional argument for rejecting the Taxpayer's treatment of the loss as an ordinary loss.

As stated above, [redacted] began questioning the value assigned to the [redacted] stock in the Acquisition Agreement and apparently threatened the Taxpayer with lawsuits arising out of the Taxpayer's misrepresentations on the profitability of [redacted]. The parties resolved this dispute by entering into the Exchange Agreement. According to [redacted], the resolution reflects the parties' agreement that the parties overstated the value of the [redacted] stock at the time of the merger. [redacted] treated the receipt of the Taxpayer's shares of [redacted] stock consistently with this characterization. That is, [redacted] allocated its basis in [redacted] stock among the shares received during the reorganization in [redacted] and the shares received from the Taxpayer in [redacted].

We believe that [redacted]'s characterization of the transaction reflects the true substance of the Taxpayer's transfer of [redacted] stock to [redacted]. The transaction, therefore, involves a reduction of the purchase price paid to the Taxpayer in the merger of [redacted]. As such, the transaction is intimately

tied to the merger. And the gain or loss realized from the transaction should have the same character as any gain or loss realized on the merger. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

B. SERVICE'S PROPOSAL

(b)(7)a, (b)(7)e [redacted]

(b)(7)a, (b)(7)e [redacted]

(b)(7)a, (b)(7)e [redacted]

If you have any questions, please call the undersigned at (619) 557-6014.

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